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IN THE UNITED STATES COURT OF APPEALS  
FOR THE NINTH CIRCUIT

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COMMISSIONER OF INTERNAL REVENUE,

Petitioner

v.

OSCAR E. BAAN and EVELYN K. BAAN,

Respondents

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ON PETITION FOR REVIEW OF THE DECISION OF THE TAX  
COURT OF THE UNITED STATES

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BRIEF FOR THE PETITIONER

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OPINION BELOW

The findings of fact and opinion of the Tax Court (I-R. 79-127)<sup>1/</sup>  
are reported at 45 T.C. 51.

JURISDICTION

The petition for review (I-R. 129-131) involves income taxes for the taxable year 1961. On February 11, 1963, the Commissioner of Internal Revenue mailed to taxpayers notice of a deficiency, asserting a deficiency in those taxes of \$284.44. (I-R. 18-21.) Within ninety days thereafter, on or about March 5 or March 7, 1963, taxpayers filed a petition with the

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<sup>1/</sup> "I-R." references are to Volume one of the record on appeal.

Tax Court for a redetermination of that deficiency under the provisions of Section 6213 of the Internal Revenue Code of 1954. (I-R. 1, 4-17.) The decision of the Tax Court was entered on October 20, 1965. (I-R. 3, 128.) The case is brought to this Court by a petition for review filed January 13, 1966 (I-R. 129-131), within the three-month period prescribed in Section 7483 of the Internal Revenue Code of 1954. Jurisdiction is conferred on this Court by Section 7482 of that Code.

#### QUESTION PRESENTED

Pacific transferred assets used in the conduct of telephone business in three northwestern states to a new corporation (Northwest) in exchange for the latter's stock and a \$200,000,000 demand note. In 1961, Pacific distributed to its shareholders rights (represented by transferable stock purchase warrants) to purchase 57% of the Northwest stock at a price of \$16 per share. The Northwest stock purchased by taxpayers, shareholders of Pacific, had a fair market value of \$26 per share on the date of purchase. The stock rights had been issued by Pacific on the basis of one right for each share of Pacific stock held, with a total of six rights (plus payment of \$16) necessary to purchase one share of Northwest stock.

The question presented is:

Whether the Tax Court erred in rejecting the Commissioner's determination that the difference between the purchase price (\$16) and the fair market value of the Northwest stock (\$26) constituted a taxable dividend to taxpayers rather than a nontaxable distribution under Section 355 of the Internal Revenue Code of 1954.

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STATUTES AND REGULATIONS INVOLVED

The relevant provisions of the Internal Revenue Code of 1954 and the Treasury Regulations are set forth in Appendix A, infra.

STATEMENT

During 1961, taxpayers Oscar E. Baan and his wife, Evelyn K. Baan, owned 600 shares of the common stock of Pacific Telephone and Telegraph Company (Pacific). (I-R. 81.) In that year, taxpayers received 600 stock rights, represented by transferable stock purchase warrants issued by Pacific, entitling them to purchase one share of the common stock of Pacific Northwest Bell Telephone Company (Northwest) for \$16 and six stock rights. On October 11, 1961, taxpayers exercised those stock rights and, in consideration for \$1,600, received 256 shares of Northwest stock. The fair market value of Northwest common on October 5, 1961, was \$26 per share. (I-R. 99, 100.) The Commissioner determined that the difference between the fair market value of the Northwest stock received and the \$16 per share paid constituted a taxable dividend. Taxpayers contended that the profit realized on the exercise of their stock rights was not subject to tax. Resolution of that question turns on whether and to what extent Section 355 of the Internal Revenue Code of 1954 applies to the transaction between Pacific and Northwest and the subsequent distribution of stock rights by Pacific. <sup>2/</sup>

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<sup>2/</sup> The instant case was consolidated for trial with the case of Irving and Margaret Gordon. The Gordons are residents of New York and a petition for review with respect to their tax liability has been filed with the Court of Appeals for the Second Circuit.

The facts surrounding the transaction between Pacific and Northwest and the subsequent distribution by Pacific of stock rights through warrants are not in dispute. The detailed findings of the Tax Court are based for the most part upon stipulated facts. The facts material to the issues on review may be summarized briefly as follows:

Prior to July 1, 1961, Pacific, a California corporation furnished communication services, mainly local and long-distance telephone services, in California, Oregon, Washington and Idaho. Beginning in 1960, the California and non-California businesses of Pacific were operated in separate divisions. For multiple business reasons, the management and shareholders of Pacific decided early in 1961 that the non-California businesses should be handled by a separate corporation. Accordingly, on March 27, 1961, Pacific caused the organization of Northwest, a Washington corporation, receiving 10,000 shares of common stock for \$110,000 in cash. (I-R. 81, 87-89, 94.)

As of June 30, 1961, all of the business and properties of Pacific in Oregon, Washington and Idaho were transferred to Northwest in exchange for (1) the issuance to Pacific by Northwest of 30,450,000 shares of common stock, (2) an interest-bearing demand note in the amount of \$200,000,000, and (3) assumption by Northwest of certain liabilities of Pacific. At the close of business on June 30, 1961, Pacific ceased all operations in Oregon, Washington and Idaho, and Northwest commenced operations on July 1, 1961. (I-R. 95-96.)

An integral part of the original plan for dividing the businesses of Pacific was the sale of Northwest stock to the shareholders of Pacific. Rights were to be issued to the shareholders of Pacific which would

enable them to purchase stock in Northwest at a price to be set by Pacific's board of directors. The purpose of the sale was to provide Pacific with funds for its future operations in California. (I-R. 92.)

On August 25, 1961, Pacific's board of directors decided that the offering price of Northwest stock to the shareholders of Pacific should be \$16 per share. Pacific shareholders were to receive one transferable stock purchase warrant for each share of Pacific held, with six rights plus the payment of \$16 required to obtain one share of Northwest stock. Between the time of the issuance of the rights (September 20, 1961) and the deadline for their exercise (October 20, 1961), the fair market value of Northwest stock was no less than \$26 per share. (I-R. 100, 101-102.)

The Northwest stock disposed of by Pacific in the above-described 1961 offering amounted to approximately 57% of the total number of Northwest shares held by Pacific. It had been planned by Pacific from the outset that the remainder would be held for disposition at a later time. The remaining 43% of Northwest common held by Pacific was offered to Pacific's shareholders on June 12, 1963, at the same price (\$16 per share), the principal difference being that eight stock rights (instead of six) were required. (I-R. 98, 104-105.)

As a result of the 1961 offering, the minority shareholders of Pacific (or their assignees) acquired 1,897,891 shares of Northwest common stock. The bulk of the total of 17,446,031 shares of Northwest sold by Pacific in 1961 was acquired by American Telephone & Telegraph Company (American) which owned approximately 90% of the common stock of Pacific. American acquired 15,548,140 shares of Northwest common.

Pacific, for its part, received for the stock sold in 1961 cash in the total amount of \$279,136,496. (I-R. 85, 101.)

As of December 31, 1960, Pacific had unappropriated earned surplus in the amount of \$192,053.880.76. As of December 31, 1961, Pacific had \$176,935,190.15 of unappropriated earned surplus. There was a sufficient dollar amount of earnings and profits of Pacific in 1961 from which a 1961 dividend could have been paid by Pacific to its shareholders to cover the dollar amounts which the Commissioner contended in this case were received by taxpayers and other shareholders as dividend income. (I-R. 84.)

Subsequently, on June 12, 1963, still pursuant to the original plan for dividing the businesses of Pacific, the remaining 43% of Northwest common was offered to its shareholders on the basis of eight rights and payment of \$16 for one share of Northwest. As a result of the 1963 offering, the minority shareholders of Pacific (or their assignees) acquired 1,416,552 shares of Northwest while American acquired 11,580,456 shares. (I-R. 104-105.)

On the consolidated income tax return filed by American and its subsidiaries for the year 1961 (which return included Pacific) no gain or loss was reported on the transaction in which Pacific transferred its non-California assets to Northwest. Similarly, no gain was reported on the consolidated return (eliminating inter-company profit) on the sale of 15,548,140 shares of Northwest common by Pacific to American. Gain was reported by Pacific, however, in the amount of \$8,739,362.07, in respect to the 1,897,891 shares of Northwest sold to the minority shareholders of Pacific (or their assignees) in 1961. (I-R. 98, 101.)

In response to requests by Pacific, the Commissioner of Internal Revenue had issued a ruling letter on June 28, 1961, regarding the tax consequences of the planned division of Pacific and the distribution of Northwest stock to the shareholders of Pacific through an issue of rights. Essentially, the Commissioner ruled that, in the case of Pacific shareholders who sold their rights, the full amount realized would be ordinary income to them, and that, in the case of individual Pacific shareholders exercising their rights, the difference between the fair market value of Northwest stock (on the date the rights were exercised) and the \$16 per share price paid would be taxed to such shareholders as dividend income. (I-R. 106-107.)

On these facts, the Tax Court decided that the transaction whereby Pacific sold its non-California businesses to Northwest and then sold the Northwest stock to its own shareholders (or their assignees) qualified as a tax-free spin-off within the terms and intendment of Section 355 of the 1954 Code and that taxpayers Oscar and Evelyn Baan consequently were not taxable on the gain realized by them when they exercised their rights to acquire Northwest stock having a fair market value of \$26 per share at a cost to them of only \$16 per share. (I-R. 110-125.) From this holding the instant petition has been filed and prosecuted.

#### SPECIFICATION OF ERRORS RELIED UPON

The Tax Court erred:

1. In failing to hold that the taxpayers realized dividend income to the extent of the difference between the price which they paid for the Northwest stock, and the fair market value

2. In failing to hold that taxpayers were not entitled to nonrecognition treatment because the transaction in issue did not comply with the terms of Section 355(a)(1)(A), (C) and (D).

#### SUMMARY OF ARGUMENT

Pacific, in 1961, transferred operating assets used in the conduct of its telephone business in three states to a newly formed subsidiary, Northwest, in exchange for all of Northwest's single-class of stock (common) and a \$200,000,000 demand note. In the same year, Pacific distributed rights, represented by stock purchase warrants, to its shareholders entitling them to purchase 57% of the Northwest stock at \$16 per share. When the rights were distributed and at the time they were exercised, the fair market value of the Northwest stock (\$26) exceeded its purchase price under the rights. In these circumstances, it is settled that taxpayers, who are the shareholders of Pacific, realized a profit on the distribution of the rights which is taxable as a dividend, absent a specific statutory exemption. The Tax Court held that Section 355 of the Internal Revenue Code of 1954 accords tax-free treatment to the transaction and entered a decision in favor of taxpayers. The Commissioner's position is that no less than four objective requirements established by Section 355 have remained unsatisfied in this case. If this Court should decide that there was not full compliance with any one of those requirements, the decision of the Tax Court must be reversed.

1. What occurred in this case simulated a transaction commonly known as a "spin-off". A spin-off occurs when a parent corporation transfers a business to another corporation in exchange for the

latter's stock and then distributes the stock of the subsidiary to its own shareholders. Congress, having provided for tax-free distributions and exchanges incident to corporate reorganizations, similarly has provided (in Section 355) a way for the shareholders of the parent corporation to receive the stock of the subsidiary without recognition of gain or loss. The justification for that treatment rests upon the fact that the spin-off, although it involves an otherwise taxable distribution, is not an appropriate occasion for taxing shareholders' gain. The shareholders have retained their business in corporate solution, i.e., the same people have maintained their investment in the same group of businesses -- only the form of doing business has been changed. Nevertheless, Congress had for many years (1934-1951) withheld tax-free status from the spin-off because of its potential for use as a means of distributing corporate earnings and profits at capital gain rates. This wariness on the part of Congress is reflected in the structure and the terms of Section 355. By setting up four cumulative and detailed sets of conditions to nonrecognition treatment, the legislature plainly evidenced an intention that every spin-off for which tax benefits are claimed shall comply with the terms of each condition and that a relaxed "close enough will do" interpretation is not to be applied. ✓

2. Section 355(a)(1)(A) required Pacific to distribute "with respect to its stock \* \* \* solely stock or securities" of Northwest. ✓  
All that Pacific distributed here with respect to its stock were saleable rights to purchase the stock of Northwest, and it is established that the rights themselves do not constitute "stock

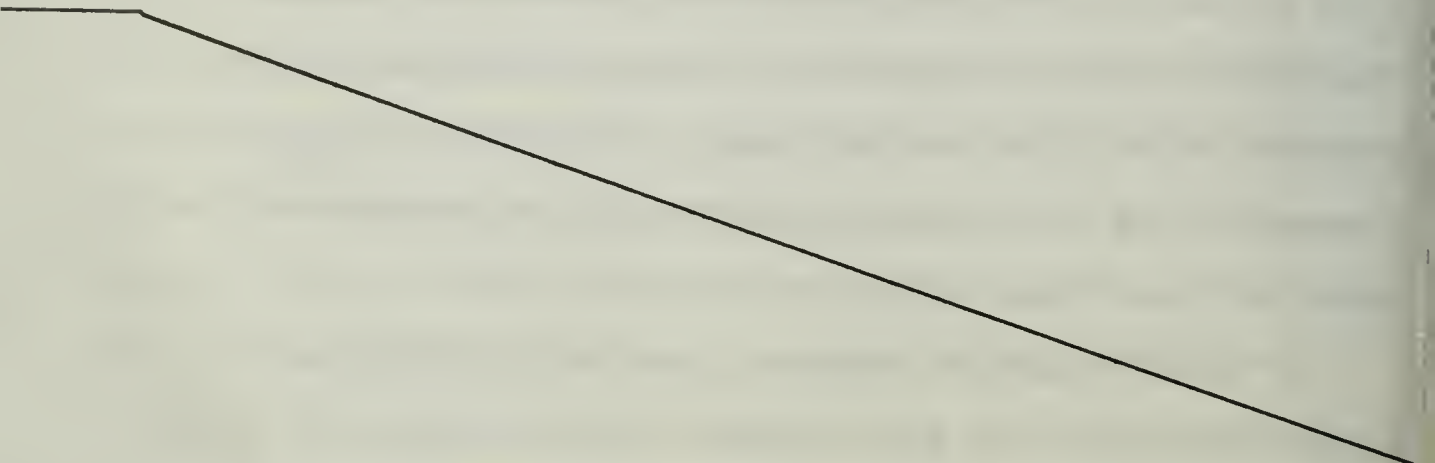
or securities". The Northwest stock, on the other hand, was sold to anyone -- shareholder or nonshareholder -- who came forward with \$16 and six rights. Beyond the fact that the Tax Court improperly ignored the separate existence of the stock rights and viewed what transpired as if an outright distribution of Northwest stock had occurred, this sale by Pacific cannot be considered a distribution "with respect to its stock". The latter phrase is used as a term of art throughout the Code and denotes a transfer without a consideration -- never a sale for cash.

3. Section 355(a)(1)(D) required that "as a part of the distribution" -- obviously the distribution "with respect to its stock" set forth in Section 355(a)(1)(A) -- Pacific had to distribute all or a controlling amount (80%) of its stock in Northwest. This requirement points up the fallacy in the Tax Court's conclusion that no intelligible legislative purpose would be served in taxing Pacific's shareholders on a transaction in which they paid \$16 per share for Northwest stock when they could have received such stock tax-free had they paid nothing for it. The disposition of control prerequisite is in keeping with the rationale of the statute that when the same people continue to own the same businesses in different forms, recognition of gain or loss is inappropriate. Congress was willing to risk the fact that shareholders of Pacific receiving Northwest stock free might turn around and sell it, thus privately "cashing in" on the earnings and profits of Pacific. A sale transaction, however, in which Pacific shareholders were required to pay substantial cash amounts (\$16 per share) to stay in the game, clearly erects a barrier to shareholder succession and falls outside the

4. In view of the fact that Section 355(a)(1)(D) required that at least 80% of the Northwest stock be distributed by Pacific, the 57% actually disposed of in 1961 (the taxable year here involved) clearly does not meet the statutory test. Admittedly, it was planned by Pacific from the outset that the remaining 43% be disposed of (as it was) nearly two years later in 1963, and this intention was regarded by the Tax Court as sufficient to make the successive distributions a single "distribution" for the purposes of Section 355. Upon examination of other provisions of Section 355, however, it readily appears that such a telescopic construction of the word "distribution" renders the statute administratively unworkable. Both Section 355(a)(1)(A) and Section 355(a)(1)(D) required that Pacific have "control" of Northwest "immediately" before the distribution, while Section 355(b)(1)(A) required that both Pacific and Northwest be engaged in active businesses "immediately" after the distribution. Section 355(b)(2)(B) required that those businesses be conducted for at least five years ending on "the date of the distribution". (Emphasis supplied.) From all of the foregoing, it is evident that the distribution is a pivotal point in time to which multiple objective standards are keyed. Phrased differently, the physically separate distributions of Northwest stock in 1961 and 1963 cannot be treated as a single transaction, for the intervening years cannot be tortured to fit within the terms "immediately" and "the date".

5. In their combined operation, Section 355(a)(1)(C) and Section 355(b)(1)(A) bar nonrecognition of gain treatment if Northwest acquired its businesses "in a transaction in which gain

or loss was recognized in whole or in part". When Pacific transferred assets to Northwest in exchange for the latter's stock and a \$200,000,000 demand note, the value of the note constituted taxable "boot" to Pacific in an otherwise tax-free exchange. This gain -- to the extent of the "boot" -- was "eliminated", however, on a consolidated income tax return filed by an affiliated group of corporations which included Pacific and Northwest. The profit on inter-company transactions concededly was properly omitted on the consolidated return, but the Tax Court erred in affording controlling effect to this reporting technicality. After all, Section 355 (b)(2)(C) speaks of "a transaction" in which gain or loss was recognized, and the character of the transaction was fixed when it occurred. What Congress was concerned with was the characterization of the acquisition transaction in the context of the provisions of Subchapter C of the Code (corporate distributions and adjustments) and it did not intend to hinge qualification for Section 355 tax benefits on the happenstance that an affiliated group of corporations subsequently decided (at the end of the taxable year) to file a consolidated income tax return.



## ARGUMENT

THE TAX COURT ERRED IN HOLDING THAT  
THE TRANSACTION WHEREBY PACIFIC SOLD  
ITS INTEREST IN ITS TELEPHONE BUSINESS  
IN THREE NORTHWESTERN STATES TO ITS  
SHAREHOLDERS CONSTITUTED A NONTAXABLE  
DISTRIBUTION WITHIN THE PURVIEW OF  
SECTION 355 OF THE 1954 CODE

The basic question involved in this case is whether the profit realized by the shareholders of Pacific on the division of that corporation into two separate corporations (Pacific and Northwest) pursuant to a so-called "spin-off" transaction is excepted from the normal tax on dividends by Section 355 of the Internal Revenue Code of 1954, Appendix A, <sup>3/</sup>infra. In tax parlance, "A spin-off occurs when a part of the assets of a corporation is transferred to a new corporation and the stock in the latter is distributed to the shareholders of the original corporation without a surrender by the shareholders of stock in the distributing corporation." S. Rep. No. 781, 82d Cong., 1st Sess., p. 57 (1951-2 Cum. Bull. 458, 499). The tax status of the spin-off, as well as the status of all other types of corporate transactions that have the potential of dividing a single corporation into two or more separate corporations is governed by a detailed and comprehensive set of limitations contained in Section 355.

In this case, for business reasons, Pacific undertook to separate its business in three northwestern states into a new corporation which was to be owned directly by the shareholders of Pacific. It is clear

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<sup>3/</sup> Hereafter, references to sections are to those of the Internal Revenue Code of 1954, unless otherwise indicated.

that Pacific could have arranged this transaction in a manner that would have complied with all of the provisions of Section 355, that is, it could have transferred the assets to Northwest in exchange for stock and then distributed the stock of Northwest to its shareholders without demanding compensation. Indeed at one point, Pacific's management actually considered handling the transaction in this fashion. (I-R. 93.) However, because of certain alleged technical problems under state law and, more fundamentally, because Pacific desired to use the division of its business as a means of raising revenue for its California operations (I-R. 92, 93), it decided to carry out the transaction in the manner involved here. Instead of transferring the assets to Northwest for stock or securities alone, Pacific received in addition a \$200,000,000 demand note, and instead of simply distributing the Northwest stock, Pacific distributed stock rights entitling its shareholders to purchase the stock of Northwest. Thus, Pacific sold rather than distributed the portion of its business conducted in the three northwestern states and in so doing, it engaged in a transaction that is outside both the limited purpose of Section 355 and the literal terms of that section.

A. Absent any statutory exemption, the distribution of rights by a corporation may be taxed as dividend income to its shareholders upon their exercise

A shareholder's receipt of property distributed by a corporation with respect to its stock is, of course, ordinarily a fully taxable event on which the entire gain must be recognized (Section 301, Appendix infra) and any claim for nonrecognition must be based upon a specific statutory exception. Turnbow v. Commissioner, 368 U.S. 337, 339-340.

It is equally clear that when a corporation undertakes to sell property to its shareholders at less than its fair market value, the difference between the purchase price and fair market value is fully taxable as a dividend. Treasury Regulations on Income Tax (1954 Code), Section 1.301-1(j), and Timberlake v. Commissioner, 132 F. 2d 259 (C.A. 4th). See also, Palmer v. Commissioner, 302 U.S. 63. However, when the distribution is effected through the use of rights to purchase property of the distributing corporation (including stock of other corporations owned by the distributing corporation), the Supreme Court's decision in Palmer and a subsequent decision of the Second Circuit in Choate v. Commissioner, 29 F. 2d 684 (and cf. Gibson v. Commissioner, 133 F. 2d 308 (C.A. 2d)), add a qualification to the above rule.

In Palmer, a corporation distributed to its shareholders rights to purchase stock of another corporation owned by it. At the time the rights were distributed there was no "spread" between the fair market value of the offered stock and the purchase price of the stock as called for by the rights. However, by the time the rights were exercised the value of the offered stock exceeded the price called for by the rights. The Court held that since no "spread" existed on the date the rights were distributed there was no intention to declare a dividend and the profit ultimately realized because such a spread had developed by the date of exercise did not constitute a dividend. Thereafter, in Choate, the Second Circuit was confronted with a situation in which there was a "spread" between the value of the offered stock and the purchase price called for by the rights on the date of distribution. In harmony with Palmer, the Court held that the existence of the "spread" indicated an intention to declare

a dividend (cf. Commissioner v. LoBue, 351 U.S. 243), but since stock rights were in the nature of an option, their exercise rather than their receipt was the proper time to determine the extent of the dividend. The amount of the dividend was the lower of the "spread" on the date of issue or the "spread" on the date of exercise.

In the instant case, it is clear that Pacific purposely distributed rights which set a purchase price for the Northwest stock below the fair market value of the stock. Accordingly, the situation that existed at the time of the distribution of the rights reflected an intention to distribute corporate earnings which, absent the application of any exemption provision of the Code, would be fully taxable as a dividend. It is equally clear under the holdings of the above cases, that while the receipt of the rights placed the shareholders in a position to realize dividend income, the extent of the dividend is not finally determined or subject to tax until the rights are exercised. Finally, the Tax Court found (I-R. 100, 110, fn. 5) that the value of the Northwest stock on the date of exercise of the rights did not exceed the value of the Northwest stock on the date of issuance of the rights, so that the limitation announced in Choate is inapplicable here. Thus, unless taxpayers can affirmatively establish that the profit resulting from the exercise of the rights to purchase Northwest stock was excepted from Section 301 by Section 355, that profit is fully subject to tax at dividend rates.

B. The purpose and legislative history of Section 355

Congress first permitted the tax-free treatment of the spin-off transaction in Section 203(c) of the Revenue Act of 1924, c. 234, 43 Stat. 253. That section classified as a "reorganization" the transfer

by a corporation of some or all of its property to a second corporation if the first corporation or its stock holders were in control (80% stock ownership) of the second corporation. It provided that no gain or loss was to be recognized by the shareholders of the first corporation if stock of the second corporation was distributed to them during the course of the reorganization. It soon became apparent, however, that if literally applied, Section 203(c) could lead to wide-spread tax avoidance. Arguably, it would have permitted the transfer of cash or other liquid assets to a new corporation whose stock could then be distributed to the shareholders of the old corporation who in turn would be in a position to liquidate the new corporation and receive the cash or liquid assets as a liquidating distribution taxable at capital gains rates. This was the very transaction involved in the landmark case of Gregory v. Helvering, 293 U.S. 465.

During the pendency of the Gregory litigation, Congress in 1934 eliminated the provision which characterized the spin-off transaction as a nontaxable reorganization (Revenue Act of 1934, c. 277, 48 Stat. 680). Thereafter, from 1934 until 1951, and irrespective of whether it served a legitimate business need or was part of a tax avoidance scheme, the spin-off transaction resulted in the shareholders being fully taxable at dividend rates to the extent that the fair market value of the stock received reflected earnings and profits of the distributing corporation.

Then, in the Revenue Act of 1951, c. 521, 65 Stat. 452, Congress was persuaded that business reasons could exist which would justify according tax-free status to the division of a single corporation into one or more corporations each of which is to be owned directly by the

shareholders. It reinstated nonrecognition treatment to certain limited spin-offs, and, as an ultimate safeguard, Congress provided that in all events, dividend treatment would be accorded the transaction even if it would otherwise qualify under the spin-off provisions if the transaction was principally used as a "device" for distributing earnings and profits. Section 112(b)(11) of the Internal Revenue Code of 1939, as added by Section 317 of the Revenue Act of 1951, c. 521, 65 Stat. 452. Thereafter, in the Internal Revenue Code of 1954, Congress sought to create a single set of limitations that would govern all forms of transactions having a divisive potential (including the so-called split-offs and split-ups as well as the spin-offs). All such transactions were to be tested under the provisions of Section 355, and that section, in addition to tightening and narrowing the basic prerequisites for non-recognition, also carried over the "device" provision that was part of the 1954 legislation. S. Rep. No. 1622, 83d Cong., 2d Sess., p. 274 (3 U.S.C. Cong. & Adm. News (1954) 4621, 4912-4913).

In sum, an examination of the history of Section 355 and its predecessors indicates that Congress has been much concerned over the years with whether there was a need to accord tax-free status to corporate divisions and stock distributions. This concern is clearly manifested in the provisions of Section 355 which have been carefully drafted to delineate a narrow range of transactions that are entitled to the preferred treatment accorded by that section.

The fact that Section 355 is an exemption provision would, standing alone, require that its terms be strictly construed. As the Supreme Court observed in Helvering v. Northwest Steel Mills, 311 U.S. 46, 49:

It has been said many times that provisions granting special tax exemptions are to be strictly construed.

Measured by this sound standard it is probably not necessary to go beyond the plain words of \* \* \* [the tax statute pertinent to that case] in search of the legislative meaning.

Beyond that, however, the terms and structure of Section 355 militate against the relaxed construction adopted by the Tax Court. In the ascertainment of legislative intent, there is need to keep in view the structure of the statute, and the relation, physical and logical, between its parts. Duparquet Co. v. Evans, 297 U.S. 216, 218. The extreme length and complexity of Section 355, imposing cumulative prerequisites to the nonrecognition of gain or loss, reflect the wariness of Congress in dealing with an exemption which, long experience had shown, might be used to spring earnings and profits tax-free. Although Congress may have been persuaded that corporate divisions for business purposes should not be inhibited by the recognition of gain or loss to shareholders whose economic positions have in substance remained the same, the clear intention of Congress manifested in Section 355 is that, at a minimum, all exempted divisions would comply with every one of the prerequisites set forth in the statute.

C. Pacific did not "distribute" Northwest stock to taxpayers "with respect to its stock" as required by Section 355(a)(1)(A)

Section 355(a)(1)(A) establishes as the first of four prerequisites delineating the type of transaction which qualifies for nonrecognition that the corporation [Pacific] distribute "to a shareholder, with respect

to its stock \* \* \* solely stock or securities of a corporation \* \* \* which it controls immediately before the distribution." (Emphasis supplied.) In this case, Pacific did not "distribute" Northwest stock "with respect to its stock." Rather, it sold Northwest stock having a market value of \$26 for six stock rights and \$16. The only thing Pacific distributed "with respect to its stock" were stock rights, and such rights are not "stock or securities," but only options to purchase stock. Helvering v. Southwest Corp., 315 U.S. 194;<sup>4/</sup> Section 1.355-1(a), Treasury Regulations on Income Tax (1954 Code), Appendix A, infra. The Tax Court dismissed this deviation from the terms of Section 355 with the astonishing statement that "The stock of Northwest was literally 'distributed' to petitioners, albeit for a consideration \* \* \*." (I-R. 1) This statement is completely unfounded. Anyone who had six rights and \$16 was entitled to receive "with respect to" that consideration alone one share of Northwest stock -- it made absolutely no difference whether that individual had been a shareholder of Pacific or had purchased those rights on the open market.

It is important to note that the Tax Court attaches to the phrase "distributes to a shareholder, with respect to its stock" -- as it appears in Section 355(a)(1)(A)(i) -- a meaning foreign to its employment in other provisions of the Internal Revenue Code. Shortly stated, a distribution by a corporation with respect to its stock never means a sale

<sup>4/</sup> The Supreme Court plainly stated that stock purchase warrants are not voting stock. The distribution of voting stock is necessary to qualify under Section 355(a)(1)(D)(ii) which incorporates the "control" definition in Section 368(c), Appendix A, infra.

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to shareholders for a cash consideration. The sole consideration permitted by Section 355 is an exchange of stock or securities, relevant to transactions such as the split-up and split-off not in issue here.<sup>5/</sup> See Section 355(a)(1)(A)(ii) and (a)(2)(B).

Whatever meaning may be attached to the word "distribute" standing alone or in a different context, the phrase "distribution \* \* \* with respect to \* \* \* stock" is a term of art with a consistent meaning throughout the Code. It is always used to refer to distributions without consideration, not sales. See Section 301 (distributions of property), Section 305 (distributions of stock and stock rights), Section 307 (basis of stock and stock rights acquired in distributions), Section 311, Appendix A, infra (taxability of corporations on distribution), and Section 312 (effect of a distribution on corporate earnings and profits).<sup>6/</sup> For example, Section 311(a) specifically provides that a corporation shall not recognize gain on a distribution ("with respect to its stock") of its stock or property. It is apparent that a distribution with respect to stock cannot encompass a sale of property, for on a sale the corporation

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<sup>5/</sup> The split-off involves the same type of transaction as the spin-off except that the shareholders surrender part of their stock in the parent corporation in exchange for stock in the subsidiary. The parent corporation in a split-up distributes the stock of the subsidiary to one group of shareholders in exchange for all of their stock in the parent; those shareholders' interest in the parent is thus liquidated whereas they become the sole owners of the subsidiary. See Bittker, Federal Income Taxation of Corporations and Shareholders (Student ed., 1963), p. 322.

<sup>6/</sup> Note that Section 316, which defines a dividend, is not limited to distributions with respect to stock, but includes "any distribution of property made by a corporation to its shareholders \* \* \* out of its earnings and profits" and "every distribution is made out of earnings and profits to the extent thereof." Therefore, a dividend may include transactions other than a distribution with respect to stock, the latter term being more restrictive.

would be required to recognize gain to the extent that the purchase price exceeded the adjusted basis of the property.<sup>7/</sup> Sections 1001, 1002, Appendix A, infra. There is a stated exception to the general rule of Section 311 which further confirms that no money or property is to pass from the shareholder in consideration for a distribution with respect to stock. It applies where property subject to a liability is distributed to a shareholder "with respect to \* \* \* stock" (whether or not the shareholder assumes the liability), and the amount of the liability exceeds the adjusted basis of the distributed property. In that circumstance, the statute provides that "gain shall be recognized to the distributing corporation in an amount equal to such excess as if the property distributed had been sold at the time of the distribution. Section 311(c). Although no consideration passes on such a distribution, there nonetheless may be a realization of gain by the distributing corporation that should be taken into account at that time as if a sale had occurred. The very fact that Congress found it necessary to create a special exception as to property subject to a liability establishes that a distribution with respect to stock does not include a sale. Accordingly, it is reasonable, and in step with the normal rules of statutory interpretation, to conclude that the insertion in Section 355 of the term distribution "with respect to \* \* \* stock" was intended to impose a special condition on the spin-off consistent with the meaning of that critical phrase as it is used throughout the Code.

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<sup>7/</sup> Pacific reported taxable gain in the amount of \$8,739,362.07 which it realized in selling Northwest stock to minority shareholders. (I-R. 101)

D. Pacific did not distribute with respect to its stock control of Northwest as required by Section 355(a)(1)(D)

As previously stated, supra, the structure of Section 355 is a succession of cumulative requirements which must be met before a spin-off may be afforded nonrecognition treatment. In Section 355(a)(1)(D) it is provided that "as part of the distribution" the distributing corporation must "distribute" (i) all of the stock in the controlled corporation, or (ii) an amount of stock constituting "control" within the meaning of Section 368(c), Appendix A, infra. In the latter provision "control" is defined as ownership of at least 80% of voting stock and 80% of all other stock of a corporation.

Reserving for later discussion the point that Pacific parted with only 57% of the stock of Northwest in 1961, it should be clear that the terms "as part of the distribution" and "distributes" in Section 355(a)(1)(D) refer to the "distribution \* \* \* with respect to its stock" required by Section 355(a)(1)(A). That being so, the argument here that Pacific did not distribute "control" of Northwest "with respect to its stock" is a mere restatement of the prior argument with one significant difference; it provides a clearer answer to the reasoning of the Tax Court (I-R. 117):

If Congress had intended that a distribution of the Northwest stock be treated as tax-free when made without consideration, it is inconceivable that it could have intended the transaction to result in taxable income to the distributees where they paid out money in connection with receiving such stock. [Emphasis in original.]

To be sure, Congress may grant or withhold tax benefits for a sound reason or for no reason at all. But when the distribution of "control" requirement in Section 355(a)(1)(D) is viewed in the light

of the purpose of Section 355 and other nonrecognition provisions of the Code, a rational basis for disallowance emerges. It is beyond argument that the fundamental basis for nonrecognition of gain or loss under Section 355 (and the standard reorganization provisions) is that no tax should be imposed when the same people continue to own the same businesses with only formal changes in the business organization. These mere formal changes properly have been regarded by Congress as an inappropriate occasion for recognition of gain or loss by the shareholders.

Applying that principle to the facts of the case at bar, it will be observed that the issuance of transferable stock rights, the exercise of which requires substantial cash payments by the shareholders, predictably will diminish the continuity of ownership. Section 355(a)(1)(A) and (D) prevents the distributing corporation from erecting such a barrier to shareholder succession. Those provisions were designed to eliminate all such sale transactions by requiring that control be distributed with respect to the distributing corporation's stock -- i.e., transferred to the parent corporation's shareholders without requiring them to pay anything. Congress ran the risk that a shareholder of the distributing corporation receiving a share of the controlled corporation for nothing might turn around and sell it, privately "cashing in" on the distributing corporation's earnings and profits, but Congress wanted assurance that the process of distribution would not in itself give impetus to the impairment of the continuity of shareholder interest. Since Pacific did not distribute at least 80% of Northwest's stock (i.e., "control") to its shareholders without consideration, it did not meet the explicit

E. Pacific did not distribute control of Northwest in a single distribution as required by Section 355(a)(1)(D)

In any event, Section 355(a)(1)(D) unquestionably requires that the distributing corporation part with control (at least 80% of voting stock and all other stock) of the controlled corporation. This divestiture requirement was intended "to prevent a parent corporation from making periodic distributions of small amounts of stock and securities in a subsidiary as a substitute for ordinary dividends." Bittker, supra, p. 338. Beyond that, however, it will be demonstrated that if anything other than a single distribution was intended under Section 355(a)(1)(D), the provision would be administratively unworkable.

Pacific disposed of control of Northwest in successive and widely-spaced steps. In 1961 (the taxable year involved in this litigation) Pacific distributed stock purchase rights and sold only 57% of the Northwest common which it held. Not until 1963, almost two years later, did it dispose of the remaining 43% of Northwest common. Consequently, as of 1961, Pacific had divested itself of neither "all" of the Northwest common nor of 80% of it, as the statute plainly requires. The Tax Court accommodated itself to these facts with the conclusion that since the successive distributions had been planned that way from the outset, they added up to a single distribution within the purview of Section 355. (I-R. 109, fn. 4.)

Assuredly, it was not argued below and it is not argued now that Pacific did not plan to give up all of the Northwest stock within a span

of two years.<sup>8/</sup> But it does seem odd that the state of mind of those in control of the distributing corporation should have the effect of transforming two distributions into one. Presumably, the Tax Court would have permitted Pacific to relinquish only 10% of the Northwest common which it owned each year for ten years (with "control" passing in the eighth year) so long as Pacific's management planned it that way. In the hypothetical case, Pacific's shareholders and the Commissioner would stand by for eight years (extending the period of limitations by consents) until it could be established that the disposition was indeed carried out as planned.

Other administrative difficulties would follow from the Tax Court's loose construction of the statute. Both Section 355(a)(1)(A) and Section 355(a)(1)(D) focus on the requirement that the distributing corporation be in "control" of the controlled corporation "immediately before" the distribution. Viewed from the other end, Section 355(b)(1)(A) requires that "immediately after the distribution" both the distributing and controlled corporation must be engaged in an active business, and Section 355(b)(2)(B) requires that such business must have been conducted for a period of five years ending on "the date of the distribution." All of these requirements make it apparent that the date of the distribution is a pivotal moment in time upon which these objective tests depend. Cf. Helvering v. Southwest Corp., supra, pp. 201-202. The difficulty

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<sup>8/</sup> No independent argument was made below as to what distinguishes "a distribution" from "successive distributions" as a matter of law. That omission does not constitute any obstacle to consideration of the point on review by this Court, since the legal argument presented here does not raise any question of fact and does not question any finding of fact by the court below. See Jack Ammann Photogrammetric Engineers, Inc. v. Commissioner, 341 F. 2d 466 (C.A. 5th); Commissioner v. Chase Manhattan Bank, 259 F. 2d 231, 237-238 (C.A. 5th); Smith Engineering Co. v. Rice, 102 F. 2d 492,

of determining whether an active business has been conducted for a period of five years ending on the "date of the distribution" would be reason enough for concluding that Congress contemplated only a single distribution occurring at a fixed point in time. Furthermore, Pacific surrendered its (80%) control of Northwest in 1961 and consequently did not have that requisite control of Northwest "immediately before" the second distribution in 1963. Section 355(a)(1)(A) and (a)(1)(D). In short, the physically separate dispositions of Northwest stock cannot be treated as a single transaction, for the years separating them cannot be made to fit within the word "immediately" and the term "the date."

Of course, the foregoing does not mean that the shareholders of the distributing corporation must physically receive the controlled corporation's stock on any particular day. All that is contended here is that some date must be capable of being viewed as the date on which the distribution took place. It is sufficient for present purposes that the Tax Court misinterpreted Section 355 when it held that a series of separate distributions stretching over a period of almost two years could be treated as a "single distribution" simply because they were planned that way.

F. Northwest acquired telephone businesses from Pacific in a transaction in which gain was "recognized" within the purview of Section 355(b)(2)(C)

The general structure of Section 355 is a laying out of four cumulative conditions to nonrecognition treatment in subsections (a)(1)(A) through (a)(1)(D). Subsection (a)(1)(C) simply states that the requirements

of subsection (b) relating to active businesses, must be satisfied. The additional detailed conditions of Section 355(b) thus incorporated are as lengthy as Section 355(a)(1) in its entirety. The single point in this mass of technical language upon which this portion of the argument is focused is the qualification for nonrecognition treatment specified in Section 355(b)(2)(C), i.e., that the active business of the controlled corporation not be acquired by it "in a transaction in which gain or loss was recognized in whole or in part." (Emphasis supplied.)

The telephone businesses were acquired by Northwest in a transaction in which gain was required to be recognized "in part" under Section 351, Appendix A, infra. Northwest obtained its operating assets from Pacific in exchange for its common stock and a \$200,000,000 demand note. Section 351(a) provides that no gain or loss shall be recognized on the transfer of property to a controlled corporation "solely in exchange for stock or securities." The \$200,000,000 demand note was not a security within the meaning of Section 351(a).<sup>9/</sup> Nonrecognition was not lost as to Pacific's receipt of Northwest stock, but the value of the note ("boot") was taxable to Pacific as "other property" under Section 351(b).

The Tax Court held, however, that whether or not the transaction in question could be characterized as one in which gain was recognizable in part, Pacific did not in fact recognize gain, which, in the Tax Court's view, was determinative. (I-R. 121.) At the end of 1961, American filed a consolidated income tax return which included both Pacific and Northwest,

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<sup>9/</sup> Corporate notes qualify as securities only when they are of sufficient duration to represent a substantial continuing interest in the corporation. See Lloyd-Smith v. Commissioner, 116 F. 2d 642 (C.A. 2d), and Cortland Specialty Co. v. Commissioner, 60 F. 2d 937 (C.A. 2d).

and any gain from inter-company transactions properly was eliminated on the consolidated return, i.e., Pacific did not report any gain on account of the receipt of the \$200,000,000 demand note. (I-R. 98.) Although it is not disputed that Pacific's gain properly was "eliminated" on the consolidated return, the question which remains is whether Congress, in disqualifying a transaction from Section 355 benefits if gain or loss was "recognized" on the acquisition of a business, used that term only in the context of other nonrecognition provisions of Subchapter C, or intended qualification under Section 355 to hinge upon whether the corporations involved decided to file a consolidated income tax return at the end of the year.

Parenthetically, it must be observed that the Tax Court, in its consideration of the other provisions of Section 355, seemed preoccupied with the question of whether literal interpretations urged by the Commissioner might frustrate the legislative purpose behind Section 355. Yet, at this point in its deliberations, the Tax Court apparently never considered what intelligible legislative purpose would be served by making qualification under Section 355 depend upon the happenstance that an affiliated group of corporations subsequently elected to file a consolidated return.

It is far more reasonable to conclude that in Section 355(b)(2)(C) Congress was concerned with the character of the transaction in which the business was acquired and did not intend to make controlling other sections of the Internal Revenue Code which have no direct relation to corporate distributions and adjustments. Viewed in that light, the character of the transaction in which Northwest acquired the telephone business from Pacific was one in which gain was recognized "in part"

under Section 351, and for the purposes of qualifying for Section 355 benefits, that character is controlling. The manner in which the businesses were acquired -- the character of the transaction -- was the subject of legislative concern, and the unrelated option to report income on a consolidated return (eliminating inter-company profit) does not relate back to change the character of such transaction. <sup>10/</sup>

#### CONCLUSION

For the reasons stated, Section 355 is not applicable to the facts of this case, and the decision of the Tax Court that it is should be reversed. The Tax Court may consider on remand the alternative arguments of taxpayers based on other provisions of the Code.

Respectfully submitted,

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OCTOBER, 1966.

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<sup>10/</sup> Sections 356(b) and 361(b), Appendix A, infra, provide that when "boot" is received it is taxable either to the corporation receiving it or (if distributed by the corporation to its shareholders) to the shareholders. Which of the two happens to receive the "boot" has no bearing on whether the reorganization falls within the terms of the nonrecognition provisions. If, in the instant case, Pacific had distributed the \$200,000,000 demand note (or its proceeds) to its shareholders, they would have recognized gain "in part" on the distribution and Section 355(b)(2)(C) would disqualify nonrecognition treatment on the subsequent exercise of the stock rights. It follows that Congress did not intend the qualification of a transaction under Section 355 to turn on whether Pacific decided to retain or distribute the note.

CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated: \_\_\_\_\_ day of \_\_\_\_\_, 1966.

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Attorney



APPENDIX A

Internal Revenue Code of 1954:

SEC. 301. DISTRIBUTIONS OF PROPERTY.

(a) In General.--Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

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(c) Amount Taxable.--In the case of a distribution to which subsection (a) applies --

(1) Amount constituting dividend.--That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

(2) Amount applied against basis.--That portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock.

(3) Amount in excess of basis.--

(A) In general.--Except as provided in subparagraph (B), that portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property.

(B) Distributions out of increase in value accrued before March 1, 1913.--That portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock and to the extent that it is out of increase in value accrued before March 1, 1913, shall be exempt from tax.

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(26 U.S.C. 1964 ed., Sec. 301.)

SEC. 311. TAXABILITY OF CORPORATION ON DISTRIBUTION.

(a) General Rule.--Except as provided in subsections (b) and (c) of this section and section 453(d), no gain or loss shall be recognized to a corporation on the distribution, with respect to its stock, of--

- (1) its stock (or rights to acquire its stock), or
- (2) property.

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(c) Liability in Excess of Basis.--If--

(1) a corporation distributes property to a shareholder with respect to its stock,

(2) such property is subject to liability, or the shareholder assumes a liability of the corporation in connection with the distribution, and

(3) the amount of such liability exceeds the adjusted basis (in the hands of the distributing corporation) of such property,

then gain shall be recognized to the distributing corporation in an amount equal to such excess as if the property distributed had been sold at the time of the distribution. In the case of a distribution of property subject to a liability which is not assumed by the shareholder, the amount of gain to be recognized under the preceding sentence shall not exceed the excess, if any, of the fair market value of such property over its adjusted basis.

(26 U.S.C. 1964 ed., Sec. 311.)

SEC. 351. TRANSFER TO CORPORATION CONTROLLED BY TRANSFEROR.

(a) General Rule.--No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property.

(b) Receipt of Property.--If subsection (a) would apply to an exchange but for the fact that there is received, in addition to the stock or securities permitted to be received under subsection (a), other property or money, then--

(1) gain (if any) to such recipient shall be recognized, but not in excess of--

(A) the amount of money received, plus

(B) the fair market value of such other property received; and

(2) no loss to such recipient shall be recognized.

(c) Special Rule.--In determining control, for purposes of this section, the fact that any corporate transferor distributes part or all of the stock which it receives in the exchange to its shareholders shall not be taken into account.

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(26 U.S.C. 1964 ed., Sec. 351.)

SEC. 355. DISTRIBUTION OF STOCK AND SECURITIES OF A CONTROLLED CORPORATION.

(a) Effect on Distributees.--

(1) General rule.--If--

(A) a corporation (referred to in this section as the "distributing corporation")

(i) distributes to a shareholder, with respect to its stock, or

(ii) distributes to a security holder, in exchange for its securities,

solely stock or securities of a corporation (referred to in this section as "controlled corporation") which it controls immediately before the distribution,

(B) the transaction was not used principally as a device for the distribution of earnings and profits of the distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device),

(C) the requirements of subsection (b) (relating to active businesses) are satisfied, and

(D) as part of the distribution, the distributing corporation distributes--

(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or

(ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368(c), and it is established to the satisfaction of the Secretary or his delegate that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax,

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

(2) Non pro rata distributions, etc.--Paragraph (1) shall be applied without regard to the following:

(A) whether or not the distribution is pro rata with respect to all of the shareholders of the distributing corporation,

(B) whether or not the shareholder surrenders stock in the distributing corporation, and

(C) whether or not the distribution is in pursuance of a plan of reorganization (within the meaning of section 368(a)(1)(D)).

(3) Limitation.--Paragraph (1) shall not apply if--

(A) the principal amount of the securities in the controlled corporation which are received exceeds the principal amount of the securities which are surrendered in connection with such distribution, or

(B) securities in the controlled corporation are received and no securities are surrendered in connection with such distribution.

For purposes of this section (other than paragraph (1)(D) of this subsection) and so much of section 356 as relates to this section, stock of a controlled corporation acquired by the distributing corporation by reason of any transaction which occurs within 5 years of the distribution of such stock and in which gain or loss was recognized in whole or in part, shall not be treated as stock of such controlled corporation, but as other property.

(4) Cross reference.---

For treatment of the distribution if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered), see section 356.

(b) Requirements as to Active Business.---

(1) In general.---Subsection (a) shall apply only if either--

(A) the distributing corporation, and the controlled corporation (or, if stock of more than one controlled corporation is distributed, each of such corporations), is engaged immediately after the distribution in the active conduct of a trade or business, or

(B) immediately before the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged immediately after the distribution in the active conduct of a trade or business.

(2) Definition.---For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if--

(A) it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged,

(B) such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution,

(C) such trade or business was not acquired within the period described in subparagraph (B) in a transaction in which gain or loss was recognized in whole or in part, and

(D) control of a corporation which (at the times of acquisition of control) was conducting such trade or business--

(i) was not acquired directly (or through one or more corporations) by another corporation within the period described in subparagraph (B), or

(ii) was so acquired by another corporation within such period, but such control was so acquired only by reason of transactions in which gain or loss was not recognized in whole or in part, or only by reason of such transactions combined with acquisitions before the beginning of such period.

(26 U.S.C. 1964 ed., Sec. 355.)

#### SEC. 356. RECEIPT OF ADDITIONAL CONSIDERATION.

(a) Gain on Exchanges.--

(1) Recognition of gain.--If--

(A) section 354 or 355 would apply to an exchange but for the fact that

(B) the property received in the exchange consists not only of property permitted by section 354 or 355 to be received without the recognition of gain but also of other property or money,

then the gain, if any, to the recipient shall be recognized, but in the amount not in excess of the sum of such money and the fair market value of such other property.

(2) Treatment as dividend.--If an exchange is described in paragraph (1) but has the effect of the distribution of a dividend, then there shall be treated as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be treated as gain from the exchange of property.

(b) Additional Consideration Received in Certain Distributions.--If--

(1) section 355 would apply to a distribution but for the fact that

(2) the property received in the distribution consists not only of property permitted by section 355 to be received without the recognition of gain, but also of other property or money,

then an amount equal to the sum of such money and the fair market value of such other property shall be treated as a distribution of property to which section 301 applies.

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(26 U.S.C. 1964 ed., Sec. 356.)

SEC. 361. NONRECOGNITION OF GAIN OR LOSS TO CORPORATIONS.

(a) General Rule.--No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

(b) Exchanges Not Solely in Kind.--

(1) Gain.--If subsection (a) would apply to an exchange but for the fact that the property received in exchange consists not only of stock or securities permitted by subsection (a) to be received without the recognition of gain, but also of other property or money, then--

(A) if the corporation receiving such other property or money distributes it in pursuance of the plan of reorganization, no gain to the corporation shall be recognized from the exchange, but

(B) if the corporation receiving such other property or money does not distribute it in pursuance of the plan of reorganization, the gain, if any, to the corporation shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property so received, which is not so distributed.

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(26 U.S.C. 1964 ed., Sec. 361.)

SEC. 368. DEFINITIONS RELATING TO CORPORATE REORGANIZATIONS.

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(c) Control.--For purposes of part I (other than section 304), part II, and this part, the term "control" means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporations.

(26 U.S.C. 1964 ed., Sec. 368.)

SEC. 1001. DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS.

(a) Computation of Gain or Loss.--The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

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(26 U.S.C. 1964 ed., Sec. 1001.)

SEC. 1002. RECOGNITION OF GAIN OR LOSS.

Except as otherwise provided in this subtitle, on the sale or exchange of property the entire amount of the gain or loss, determined under section 1001, shall be recognized.

(26 U.S.C. 1964 ed., Sec. 1002.)

Treasury Regulations on Income Tax (1954 Code):

§1.355-1. Distribution of stock and securities of controlled corporations.

(a) Application of section. \* \* \* For the purpose of section 355, stock rights or stock warrants are not included in the term "stock and securities."

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(26 C.F.R., §1.355-1.)

§1.355-2. Limitations.

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(c) Business purpose. \* \* \* Section 355 contemplates a continuity of the entire business enterprise under modified corporate forms and a continuity of interest in all or part of such business enterprise on the part of those persons who, directly or indirectly, were the owners of the enterprise prior to the distribution or exchange. \* \* \*

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(26 C.F.R., §1.355-2.)

APPENDIX B

All exhibits were admitted upon the stipulation of the parties and were incorporated in and made a part of the consolidated stipulation of facts. (I-R. 26.) A table (I-R. 71-78) lists and describes each exhibit, and sets forth the page wherein reference is made to it in the consolidated stipulation of facts (I-R. 26-70).